

This methodology was unreasonable for two fundamental reasons. First, the auditors never described the standard or identified documents that would meet the standard. After the initial scoring from the on-site visits, the only description given to BellSouth regarding additional evidence was a letter from the auditors dated March 11, 1998.⁴⁷ The letter stated [i]n order for us to consider any changes to these findings, we will need the *necessary documentation that you believe will support your position* by April 7, 1998."⁴⁸ The letter gave no direction as the type of documents the auditors believed were necessary to support a change nor the standard used to evaluate the documents submitted. Indeed, the ASD Notice was the first time BellSouth had seen or heard any articulated standard the auditors used in judging whether to re-score an item. It is completely unreasonable to merely suggest such an open-ended request, as stated in the March 11, 1998 letter, with no guidance regarding the standard or burden that had to be met.

BellSouth did provide documents that it believed supported its position, however, due to the complexity surrounding the records being audited, these documents often times required detailed explanation, including subsequent site visits. Indeed, the complexity of the records leads to the second flaw in the auditors' methodology. The methodology lacked the necessary alternate procedures needed to obtain sufficient evidence to re-score an item. Many times the explanation require more than merely finding a copy of an invoice or engineering drawing. This was especially true for situations that did not fall under one of the types of potential errors listed above.

equipment and could not be visibly seen unless the larger piece of equipment was dismantled.

⁴⁷ See copy of letter dated March 11, 1998 from Kenneth M. Ackerman, Chief, Audits Branch, to Mary L. Henze, Director, Executive and Federal Regulatory Affairs, BellSouth Corporation attached as Exhibit 4.

⁴⁸ *Id.* (emphasis added).

For example, many of the discrepancies between the auditors scoring an item as being “not found” and BellSouth’s scoring it being “found” was the result of BellSouth’s implementation of its “Power Roll-up” project. The Power Roll-up project, which BellSouth explained in great detail during the auditor’s on-site visits, fundamentally consolidated the many thousands of CPR identifiers for power equipment to 24 locally defined CPRs. This was accomplished through a software program that converted the current CPR identifiers in existing property records to one of the new CPR identifiers based on a detailed mapping table without altering the quantity, account, vintage or investment data. This results in many more manufactured items (part numbers) being identified with the same CPR. During the site visits, the auditors were using the national CPR catalog, which did not contain these locally defined CPRs, nor did BellSouth have all of the pertinent documentation at their immediate disposal in order to definitively link the found item with the new CPR. BellSouth subsequently provided the relevant documentation to the auditors that would allow them to perform this link. Unfortunately, the auditors did not seek BellSouth’s assistance and, apparently being unable to perform the link to their satisfaction, scored these items as not found.

In order to show the inadequacies of the auditors’ procedures to determine if an item should be re-scored, BellSouth engaged PriceWarehouseCoopers (“PWC”) to evaluate the auditors’ scoring results.⁴⁹ PWC’s testing focused on items that the auditors scored as either being not found, partially found, or unverified and BellSouth scored as being found.⁵⁰

To perform this test, PWC selected four locations that the auditors had included in their on-site visits. From these locations, PWC selected a sample of items that the auditors had scored

⁴⁹ PWC’s Report is attached as Exhibit 5.

⁵⁰ PWC also tested the supporting documentation for items that BellSouth agreed with the auditors scoring as being not found. This testing is discussed more thoroughly in BellSouth’s

as other than found and BellSouth had scored as being found. PWC then performed appropriate tests on these items to verify which score was accurate. On every item it tested, except one,⁵¹ PWC independently determined that the item was found and should have been scored accordingly.

PWC's test provides emphatic evidence that the methodology undertaken and the procedures performed by the auditors were inadequate to determine if an item should have been re-scored. Indeed, PWC stated that beyond the initial site visit to the central office to perform the inventory counts, "[p]roper evaluation of these items involves ... subsequent alternate procedures (i.e., review of certain other items of documentation) to reconcile items to the CPR, and potentially additional visits to the central office."⁵² Consequently, PWC concluded, "it appears that the [auditors] did not perform adequate procedures to properly evaluate the items being tested in their sample."⁵³

BellSouth contends that the entire discussion regarding the methodology, however, is pointless. No matter the methodology the auditors used to perform alternate procedures when they could not physically see a CPR identifier of a piece of equipment, the fact remains that the entire audit approach was flawed and therefore any results reached by the Bureau are unreliable. Moreover, even if the results reached by the bureau were taken at face value, the alleged missing assets would have no measurable impact on ratepayers, either now, in the past, or in the future.

Response to Issue 4.

⁵¹ This one item was a converter plant, item number 35, in Laurel, Mississippi. PWC did not dispute that the item existed, but believed it to be improperly recorded in the CPR. See PWC Report at 7 ("Based on the procedures performed, it appears that the item exists; however, [BellSouth] should correct the CPR to reflect the proper investment and bay location; therefore, we have rated this item as unverifiable, UA.")

⁵² PWC Report at 11.

⁵³ *Id.*

Accordingly, the reasonableness or validity of the auditors' methodology used in re-scoring items is of little significance in this Inquiry.

ISSUE 3: To the extent the auditors' sampling, rescoring and other methodologies were valid, whether the degree of error in the CPR records determined by the auditors is sufficient to require corrective action

The response to this Issue must be divided between alleged compliance or procedural errors and alleged investment errors. Regarding alleged investment errors, in response to Issue 1, BellSouth explained in great detail that the extrapolated error projected as missing plant is completely and irreparably flawed and cannot be used as any basis to make adjustments. Thus, the only corrective action that can be taken for investment purposes must be limited to the errors found in the actual sample items tested. In fact, BellSouth has made adjustments to its investment accounts for the sample items that it agreed could not be found.

Moreover, BellSouth contends that the Commission should not take corrective action regarding alleged compliance errors for two reasons. First, the errors alleged by the auditors were based on their interpretation of the rules. Thus, in many cases the auditors listed an item as being out of compliance with the Commission's rules, while BellSouth believes the auditors interpretation was invalid.⁵⁴ Moreover, many of the errors found by the auditors, which BellSouth agrees were out of compliance with the rules, were merely mistakes that occur in the normal course of recording these assets. Mistakes should only be a basis for corrective action to be taken by the Commission.⁵⁵

Second, the CPR requirements were established as detail rules to ensure the recording of fixed assets in a rate of return environment. They have clearly outlived their purpose in a price

⁵⁴ See PWC Report.

⁵⁵ See *infra* n. 87 and accompanying text.

cap regulation world. Accordingly, the Commission should not look to corrective action for non-compliance of backward looking out of date rules, but should take this opportunity to apply Section 10 of the 1996 Act and forbear from applying these rules on an on-going basis.

ISSUE 4: What accounting adjustments, if any, should be made to account for "missing" plant

1. Any Implication That Casts Doubt on the Acquisition of Missing Assets Should be Summarily Dismissed

A very important point of clarification must preface this issue. The language in the Report appears purposefully vague concerning the auditors' conclusions regarding the reasons for the alleged missing plant. In paragraph 36 of the Report the auditors state that their audit results "raise[] significant questions about the valuation of [BellSouth's] plant accounts At its worst, failure to provide sufficient and convincing documentation for the acquisition of the assets in question and for their placement into regulated accounts raises doubts about whether policymakers can rely on these records." It is completely irresponsible for the auditors to cast doubt on whether assets were actually acquired and placed in service. The Report specifically states that the auditors have not "completed their examination of the cost support documentation for the Hard-Wired Equipment and "for purposes of this Report, [the auditors] assume the original costs, [and therefore the acquisition of the assets,] recorded on its CPR are correct." Thus, one would assume from this statement that the auditors did not question the acquisition of assets listed in the Hard-Wired Equipment accounts CPR, and if any listed assets are not in actual service, the only cause would be a failure to properly retire the asset.⁵⁶

⁵⁶ The auditors may have intended the statement regarding doubts about the placement of assets into service to relate only to the Undetailed Investment. BellSouth explains in response to Issue 5 *infra*, however, that the Undetailed Investment can be fully substantiated and the issues associated with the account are based on differences in interpretation of the methods used to

The calculation of the proposed write off of hard-wired equipment, however, paints a less favorable story. The proposed write off is based entirely on an extrapolation of the original cost of the assets that the auditors allege are missing. Aside from the fact that this approach is unprecedented because it fails to consider the netting effect required by conducting a two-way audit,⁵⁷ the approach is also flawed because it ignores the impact of depreciation on the assets that are allegedly missing. The idea of calculating an extrapolation based on the original cost value without considering depreciation of the alleged missing assets could suggest that the auditors question whether the assets were ever acquired.⁵⁸ Such an assumption is, of course, ridiculous and BellSouth is dismayed, that it has to even dignify it with a response. However, because the auditors have purposefully failed to clarify that this is not a possibility, BellSouth wants the Commission to be abundantly clear on this issue – to the extent that any assets recorded in the CPR are missing, the cause is strictly the result of a clerical error, e.g., failing to retire an asset in a timely manner, and *never* the result of an intentional act, e.g., placing assets on the books that were never acquired.

To put this issue to rest for good, BellSouth engaged PWC to test the supporting documentation for the acquisition of the assets within the auditors' sample items deemed

account for the investment.

⁵⁷ See discussion of audit method flows in Response to Issue 1 *supra*.

⁵⁸ Ignoring depreciation in their calculation could only lead to two results, either the auditors assumed the assets had no accumulated depreciation and therefore the entire write off should be against earnings, or the assets were all fully depreciated and should be written off entirely against accumulated depreciation with no effect on net investment. As BellSouth discussed in its Response to the Report and in these comments, *see* footnote 63 *infra*, the auditors did not explain what was meant by the term "write-off." If the auditors consider all the assets they allege to be missing as improperly recorded retirements, and therefore, fully depreciated, any forced write-off should be in the form of an adjustment to reduce gross plant asset and accumulated depreciation balances with no effect on net investment. BellSouth discusses its reasoning in more detail below.

missing. Of the 1,152 sample items tested by the auditors, BellSouth agreed with the auditors that 84 of the items could not be found.⁵⁹ To perform its tests PWC “judgmentally selected a sample of [22] items [from the 84 items that were not found] and requested documentation (i.e., invoices, telephone equipment orders, etc.) to determine the appropriateness of the cost support documentation and subsequent capitalization in the CPR.”⁶⁰ PWC found supporting documentation for 21 of the items; and the remaining item had an in-place cost of only \$567. Based on these tests PWC concluded, “we did not discover any evidence of [BellSouth] inappropriately recording assets which were not acquired. ... Based on our testing of these items, it appears that [BellSouth] could substantiate the original purchase of these items.”⁶¹ Accordingly, the Commission should likewise be satisfied that there is absolutely no evidence to suggest that assets were placed in the CPR without being acquired.

BellSouth believes that it is improper for the auditors to present even an implication that the assets may not have been placed in service. Consequently, the Commission should reject and remove any suggestion or allusion to such activity in the Report when it resolves this proceeding.

2. The Proposed Write-Off cannot be Defended

Even if the auditors assumed the alleged missing assets to be untimely recorded retirements, no adjustment is necessary. The Report recommended that BellSouth “write-off” \$297.1 million, the estimate of “missing” plant obtained by the extrapolation techniques employed by the auditors. The discussion on Issue 1 fully demonstrates that the auditors sampling design and auditing procedures provide no reasonable basis to recommend a write off

⁵⁹ The original in-place cost of these 84 items amounted to \$205,231. The original in-place cost of the 1,152 sample items was \$15, 468, 046. The missing items made up only 1.33% of the total sample items (\$205,231/\$15, 468,046).

⁶⁰ PWC Report at 3.

⁶¹ *Id.* at 11.

of any estimated amount. Accordingly, no adjustment should be made for the \$297.1 million estimate made by the auditors.⁶²

Defects and errors were pervasive throughout the statistical sampling method used by the auditors. This caused the estimate the auditors calculated for missing dollar investment to be highly inaccurate and unreliable. E&Y applied corrected statistical calculations to the auditors' test results and determined that there was no statistically significant difference between the correctly calculated estimated total investment not found and zero. Thus, any request that an adjustment be made based on the auditors' extrapolation from the sample is entirely unjustified.

Moreover, even if the auditors' statistical sampling method were accepted without exception, their conclusions for the amount to be written off would likely be challenged in the professional accounting and statistical communities. For example, in determining the recommendation to write-off \$291.7 million for missing investment, the auditors stated that they "estimated the total missing plant cost to lie between \$148.8 million and \$434.6 million, with the most likely value for this cost centered around our best estimate of \$291.7 million." E&Y, however, states that "confidence intervals give a measure of the precision of the estimate, but no value contained within the interval is necessarily 'better' than any other. In a sense, values within an interval are statistically indistinguishable. Thus, a conservative approach is to use the lower bound of the interval." The recommendation that \$291.7 million be used as the adjustment, the estimate, instead of \$148.8 million, the lower interval of the auditors' range is unjustified.

⁶² BellSouth agrees with the auditors' findings regarding \$205,231 of the in-place cost of non-found assets. These are the only assets that should be written-off. See footnote 62 *infra*. BellSouth has made the proper adjustments for this amount. See PWC Report at 11.

Finally, as discussed in detail in response to Issue 2, many of the records the auditors scored as being noncompliant were actually in compliance. Moreover, in some cases, the auditors scored items as missing for compliance review, yet upon further research BellSouth determined that the compliance error did not have an impact on investment. The auditors, however, scored this as missing investment even though the asset was in existence. A mere record error is no basis to count an asset as missing and seek to have it adjusted out of the investment accounts. Investigation is needed to determine if it has an investment impact. Failure to investigate the investment impact, which caused the auditors to categorize items as missing for investment purposes, not only affected sampled items but also caused critical errors in extrapolating the results. This, of course, caused the estimate for missing investment to be significantly overstated. Indeed, when E&Y ran the auditors' sample calculation using BellSouth's score for missing investment, the estimate was immaterial.

3. Any Proposed Write-Off would have No Impact from a GAAP or Regulatory Perspective

The proper application of Generally Accepted Accounting Principles ("GAAP") and the Commission's own rules regarding the retirement of telecommunications plant in service would not require an adjustment at all. For example, conservatism does not support the proposed amount of the write off.⁶³ BellSouth will demonstrate below that from the viewpoint of creditors and investors the alleged misstatement is immaterial. Additionally, retirement of plant investment accounted for and tracked using the group or mass asset methodology does not

⁶³ BellSouth is unsure what the auditors mean by recommending that the proposed amounts "should be written off [BellSouth's] plant accounts" as used in the Conclusions and Corrective Actions and Recommendations sections of the Report. Typically, write off refers to assets that are recorded, depreciated, tracked, and individually retired. BellSouth can only assume the auditors mean that any write off of investment should conform to the accounting for retirements prescribed by Part 32 and by GAAP, as discussed below.

change the net investment, and hence the rates, which BellSouth charged under rate base rate of return regulation or under price caps with or without sharing. Because the accounting is the same for Part 32 and for GAAP, even assuming, arguendo, that the auditors' allegations of missing plant are valid, there would be no material financial or regulatory impacts resulting from the retirement of "not found" telecommunications plant in service.

a. Part 32 Accounting Rules

Because BellSouth uses the group depreciation methodology, adjustments for the write off of assets, including the amounts recommended by the Report, should be performed in the normal course of business as a delayed retirement. Such adjustments should not be accorded special accounting treatment for Part 32 or GAAP.⁶⁴

i. Group Depreciation Requirements

Group depreciation methodology is the cost recovery mechanism for telecommunications plant prescribed by Part 32 of the Commission's rules⁶⁵ and is considered the industry standard. This method also complies with GAAP.⁶⁶ Accordingly, BellSouth uses this methodology for GAAP purposes for large numbers of homogenous assets.

Group depreciation requires assets to be recorded in homogenous groups. BellSouth uses the same groups for both its GAAP and Part 32 books. Depreciation rates are developed based on the homogenous groups and not for individual assets. The total group investment balance is depreciated in aggregate rather than by individual assets.

⁶⁴ Even if the Commission ignores the facts and prescribes special accounting treatment for Part 32 purposes, any special accounting treatment should not be duplicated on the BellSouth GAAP books.

⁶⁵ 47 C.F.R. § 32.2000(f)(3)(ii).

⁶⁶ See Accounting Principles Board ("APB") 43 (9c)(5).

Upon retirement of an asset, the original cost of the asset is debited to the accumulated depreciation account and credited to the asset account. Any gross salvage received is credited to accumulated depreciation and any cost of removal is debited to accumulated depreciation. This methodology assumes that the group depreciation rate is accurate for the group as a whole and that the cost of the retired asset is being fully provided for in the accumulated depreciation account. No gain or loss is recognized for retirement of individual assets. Any gains or losses caused by over or under depreciation are averaged out over the group. Also, periodic income is not distorted upon disposition of an asset.

Part 32.2000 and Part 32.3100 set forth the basis for group depreciation requirements.

Part 32.2000(d)(1) states:

“When any item of property subject to plant retirement accounting is worn out, lost, sold, destroyed, abandoned, surrendered upon lapse of title, becomes permanently unserviceable, is withdrawn or for any other reason is retired from service, the plant accounts applicable to that item shall be credited with the original costs of the plant retired whether replaced or not...”

Part 32.3100(c) states:

“At the time of retirement of depreciable operating telecommunications plant, this account [Accumulated Depreciation] shall be charged with the original cost of the property retired plus the cost of removal and credited with the salvage value and any insurance proceeds recovered.”

Accordingly, pursuant to group depreciation methodology, adjustments to write off assets not found during a physical inventory are treated as delayed retirements. The original cost of the asset is debited to the accumulated depreciation account and credited to the asset account. The income statement is not affected because a gain or loss is not recorded.⁶⁷

⁶⁷ This theory is also followed for adjustments to “write on” assets found during a physical inventory are treated as the recovery of an asset previously retired. The original cost of the asset, estimated if not known, is debited to the asset and credited to the accumulated depreciation

ii. Extraordinary Item Treatment Considerations

Based on discussions with the Bureau, it was suggested that any write off could receive extraordinary item treatment for accounting purposes. Under this treatment, an asset(s) would be credited and an extraordinary item would be debited to an income account. Regardless of the fact that such treatment would completely and improperly ignore the accumulated depreciation associated with any assets written off, extraordinary item treatment is not appropriate for adjustments of the nature recommended by the Report for either GAAP or Part 32 accounting.

(a) GAAP Considerations

Extraordinary items are defined in Accounting Principles Board Opinion No. 30 (APB 30) as “events and transactions that are distinguished by their unusual nature and infrequency of their occurrence.” In order to meet the “unusual nature” criterion, the event or transaction should possess a high degree of abnormality and only incidentally relate to ordinary activities. The “infrequency of occurrence” criterion means events or transactions of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which an entity operates. Clearly, the rule was designed to exclude adjustments that occur frequently as a normal part of business, e.g., the retirement of plant assets. Indeed, pursuant to Paragraph 23(d) of APB 30, gains or losses for the sale or abandonment of assets are explicitly excluded from extraordinary item treatment. The basis for this accounting position is that retirement of plant is an ordinary and usual activity and included in the costs of continuing operations.

This point is underscored by the fact that BellSouth utilizes the group depreciation methodology for GAAP books. As discussed above, adjustments of this type are considered

account.

delayed retirements and charged to accumulated depreciation (i.e., a gain or loss is not recognized). As a balance sheet only adjustment, net income is not directly impacted by the retirement of assets. Accordingly, the adjustment recommended by the Report does not meet the criteria required by APB 30 and should not be treated as an extraordinary item.

(b) Part 32 Considerations

Part 32 accounting requirements for extraordinary income charges are documented in Part 32.25 and Part 32.7620. The requirements set forth in these rules are the same as those established by APB 30 requirements above and for the same reasons discussed above for GAAP, extraordinary income treatment of the adjustment for Part 32 is not appropriate.

Part 32.2000, however, details additional cost recovery considerations related to assets. Part 32.2000(g)(4) requires special accounting for asset retirements only if all the following criteria are met:

- (A) The impending retirement was not adequately considered in setting past depreciation rates.
- (B) The charging of the retirement against the reserve would unduly deplete that reserve.
- (C) The retirement is unusual in that similar retirements are not likely to recur in the future.

Although BellSouth contends retirements are inherently included in setting depreciation rates, the proposed adjustment clearly does not meet the requirements of items (B) and (C). The proposed write off for alleged missing plant clearly would not deplete the accumulated depreciation reserve. Specifically the COE reserve is \$10.6 billion. Obviously, the \$297.1 million proposed adjustment is less than 3% and is not material to the reserve balance. Moreover, inventory adjustments for plant assets are not unusual or nonrecurring but represent a normal and usual function of asset management.

Finally, even if the adjustments in question met all of the above requirements for extraordinary treatment, Part 32.2000(g)(4) requires that the loss in service value (i.e., net book value) be considered a cost of continuing operations and not an extraordinary income adjustment. Accordingly, the adjustments would be booked as follows: (1) the asset is debited to the accumulated depreciation account and credited to the asset account (i.e., normal retirement transaction); (2) the unprovided-for service loss (i.e., net book value) is debited to Account 1438, Deferred maintenance and Retirements, and credited to accumulated depreciation; and (3) the Account 1438 balance is amortized to Account 6561, Depreciation Expense, over a period approved by the Commission. Thus, any discussion of extraordinary treatment is completely misplaced and should be dismissed.

b. Regulatory Impacts

There are no regulatory impacts associated with the retirement of telecommunications plant. As the Commission knows, under the rate base rate of return paradigm, a significant component entering into the determination of rates was net plant. This component was determined by deducting the balance in Account 3100 Accumulated Depreciation from the balance in Account 2001 Telecommunications Plant in Service to arrive at the net telecommunications plant in service on which the carrier was allowed to earn the authorized rate of return. As the following table demonstrates, if plant were determined to be missing and the accounting prescribed by Part 32 is followed, there is no change in net plant.

1997 (in millions)			
	Account 2001	Account 3100	Net Plant
As Report in ARMIS	\$47,203	\$24,155	\$23,048
Retire Plant	(292)	(292)	-0-
After Retirement of Alleged Missing Plant	\$46,911	\$23,863	\$23,048

There is no change in net plant regardless of what year the retirement occurred. Net plant is not changed because telecommunications plant and accumulated depreciation are both reduced by the amount of the plant retired. Thus, even if the alleged missing plant should have been retired, there would have been no impact on the rates paid by customers under either rate base rate of return regulation, the initial rates established under price cap with sharing or the rates established under price caps with no sharing paradigms.

c. Materiality

Even assuming *arguendo* that the auditors' estimate of \$291.7 million for missing investment is proper, BellSouth does not believe this to be a material amount when GAAP's materiality standard is appropriately applied. As of December 31, 1997, BellSouth had a balance of \$47.2 billion in Account 2001 Telecommunications Plant in Service, \$24.2 billion in Account 3100 Accumulated Depreciation and net telecommunications plant in service of \$23 billion. The \$291.7 million of alleged missing plant is .64% of the Account 2001 balance, 1.25% of the Account 3100 balance and 1.30% of net telecommunications plant in service. Moreover, the alleged missing plant is less than 1% of the balance in Account 2001 at December 31, 1990. It seems totally improbable that even the most stringent application of the materiality principle applied by an extremely conservative accounting professional would require a retirement of investment based on an extrapolation of this nature, especially considering that the estimate contains a *49% margin of error*.

d. Prematurity

All of the above discussions assume that the alleged missing assets that the auditors recommend be written off are identifiable. Unless the assets are identified, no adjustment can be made to the CPR. If a write off is made only to the investment accounts, then a discrepancy will

forever exist between the subsidiary records of the CPR and the investment accounts. Moreover, any recommendation for an adjustment to the investment accounts represents a distinct dichotomy between such an adjustment and the recommendation for an inventory of the entire COE. If an inventory is performed, the results of the inventory will provide an accurate basis to adjust the CPR and the investment accounts. Accordingly, any adjustment made prior to the inventory would be premature.

ISSUE 5: What accounting corrections, if any, should be used to resolve the undetailed investment identified in the audit reports

Undetailed Investment is comprised of investment amounts that are held in this set of accounts pending being detailed and reclassified to their proper investment account. As the name implies, Undetailed Investment is composed of costs that have not been detailed to a specific investment account. These costs are made up of pre-1974 investment and current investment that is in the process of being classified. The pre-1974 investment is the result of the deployment of the automated CPR system in 1974. The plan to maintain pre-1974 as undetailed investment in this set of accounts was documented in M-295.⁶⁸ The Commission accepted M-295 pursuant to a letter dated December 24, 1968.⁶⁹ In addition, the Undetailed Investment acts

⁶⁸ M-295, Outline of Plan for a Mechanized Detailed Property Record of Central Office Equipment, dated May 22, 1968. A copy of the M-295 letter was attached as Exhibit II to BellSouth's Response to the Report Draft, filed on August 26, 1998.

⁶⁹ Letter from Mr. Kelley E. Griffith, Chief, Domestic Rates Division (for Chief, Common Carrier Bureau) to Mr. Alexander L. Scott AT&T's Vice President and Comptroller, dated December 24, 1968. Undetailed investment represents investment related to years prior to the deployment of PICS/DCPR. In his letter Mr. Griffith recognized that "...you will have two continuing property-record plans for central office equipment, viz., the new plan and the continuation of the older type record and the method of operation thereunder, including determination of retirement amounts, for plant (other than capital tools and designated plug-in items) placed prior to adoption of the new plan." Additionally, the mechanics of the plan are such that details can be included in the record at any time for any previously undetailed amounts, if it becomes practicable to compile the details. See, M-295 Part I.1.08.

as a temporary cost holder for current investment during reclassifications. As such, it is a valuable internal control tool in the accounting process. Thus, the amount of current investment in the accounts relates directly to the timing of any reclassifications in progress. It would be unrealistic to expect BellSouth to do real-time classification of these assets. Accordingly, the amounts in this set of accounts are proper until the reclassification takes place.⁷⁰

The Report makes many accusations regarding the amounts related to Undetailed Investment. These accusations appear to reflect the auditors' misunderstanding of these accounts and the methodology BellSouth uses in accounting for them. The Report states that "the only specific explanation that [BellSouth] offered for these records is that they represent a portion of the investment installed prior to the implementation of its mechanized CPR," (the pre-1974 investment). The amount of pre-1974 investment equals \$40.9 million of the total \$138.5 million in the Undetailed Investment accounts. As discussed above, this portion of Undetailed Investment is properly placed in these accounts. Until the assets associated with this investment are retired,⁷¹ it would be improper to simply eliminate this amount from the records. Such action would result in telecommunications plant being recorded below original cost which is contrary to the accounting required by the Commission's Part 32 accounting rules.

When the \$40.9 million of Undetailed Investment associated with pre-1974 investment is subtracted from the \$138.5 million, the amount in the Undetailed Investment as of July 1997, it leaves a remaining balance of \$97.6 million associated with current investments that are in the process of being detailed. BellSouth is currently reclassifying this amount to detailed

⁷⁰ BellSouth explains the amounts in this set of accounts below.

⁷¹ When a pre-1974 asset is retired from investment, a portion of the Undetailed Investment is allocated to the asset and also retired. Most of the pre-1974 assets are associated with analog equipment. Once BellSouth replaces its 1AESS switches, a significant portion of the pre-1974 analog assets will be retired or reclassified along with the associated portion of the Undetailed

investment. This is demonstrated by the fact that during the time period from July 1997 to March 1998 the amount of Undetailed Investment had decreased by \$25.5 million, approximately 18%, thus, leaving a balance of current investment to be detailed of \$72.1 million (\$97.6 million less \$25.5 million). This decline is expected to continue as ongoing work associated with investment reclassifications is completed. For example, due to an account reclassification now under way, \$34 million will be converted to detailed investment or be retired. The remaining \$38.1 million (\$72.1 million less \$34 million) represents only 0.2% of the total COE investment.

The amount in Undetailed Investment at any point in time is related to the timing of reclassification or the status of replacement of pre-1974 equipment. As previously discussed, the detailing of these amounts is a laborious process; it cannot be done on a real-time basis. Any attempt to do so would result in confusion and improper classification. Moreover, if the entire amount were forced to be eliminated by a wholesale write-off, detailed investments would be understated.⁷² Accordingly, BellSouth asserts that the amount in Undetailed Investment is properly stated.

To test this account the auditors attempted to look at Undetailed Investment at three locations they visited as part of the sample selected to test the Hard-Wired Equipment. The auditors then requested cost support documentation for 25 randomly selected entries listed in the Undetailed Investment. The Report concludes that the auditors were “unable to locate any of the Undetailed Investment during [the] on-site visits,” nor were they satisfied with cost support

Investment.

⁷² The Summary section of the Report states that the estimate of non-located dollar investment, determined by the statistical sampling process, and the Undetailed Investment cannot be substantiated. The Report appears to recommend that BellSouth be forced to “write off” both of these amounts. As demonstrated here, and will be reiterated herein, an arbitrary write-off of

provided by BellSouth. Based on this unstatistical limited review of the Undetailed Investment, the Report questions the existence of all of the Undetailed Investment and recommends that it be removed from the CPR and the plant accounts.

As explained above, the nature of the account will not allow for the auditors to select a line item from the Undetailed Investment and trace it to a physical asset. The items in the Undetailed Investment are costs that must be assigned to a physical asset. The auditors failure to accept, or comprehend, the make up of this account is absolutely no reason to suggest a wholesale write off. Moreover, the Report's claim that the auditors gave BellSouth the "opportunity ... to ... provide sufficient and convincing documentation supporting [Undetailed Investment]" is disingenuous. The opportunity to provide such documentation came in the form of "document requests" without opportunity to explain the information provided. This documentation is very complex and explanation is needed to understand how it supports the investment. The auditors' failure to allow such explanation, and to then make recommendations that it be removed from BellSouth's books and even to go so far as question the existence of the assets is grossly irresponsible. The auditors are fully aware that BellSouth's controls and practices are such that it is virtually impossible for assets to be placed onto its books without being placed into service. Accordingly, based on this explanation, no adjustment should be made to the Undetailed Investment account.

the Undetailed Investment would be inappropriate.

ISSUE 6: The recommendation of the auditors that the companies should be required to engage independent firms to perform an inventory of their entire central office equipment and provide the results to the Commission, and that the Commission should analyze the results of the inventory and direct the companies to make necessary entries to correct their CPRs and account balances

As demonstrated throughout its Response and these comments, BellSouth's investment accounts are materially accurate and the Report's estimated amount of missing Hard-Wired Equipment is the result of an improperly designed audit. If the audit had been designed properly, the results would have proven that BellSouth's investment accounts are materially and fairly stated.

BellSouth agrees that a complete inventory of assets is an important and necessary control to ensure that its records are continually improving and remain accurate. In fact, beginning in 1972, BellSouth has employed an inventory and reconciliation process for both its COE Hard-Wired and Plug-In Equipment on a cycle basis.⁷³ The inventory and reconciliation process is performed on one-eighth of the Hard-Wired Equipment each year. Thus, the entire Hard-Wired Equipment is inventoried over an eight-year period.⁷⁴ Additionally, certain high activity offices, as determined by each state, are inventoried and reconciled every eighteen months. For Plug-In Equipment, BellSouth employs a statistical sampling method to determine the locations to inventory. The sampling method, probability proportional to size ("PPS"), concentrates on selecting locations with the greatest amount of Plug-In Equipment investment. Also, the five locations with the highest dollar value of investment are inventoried annually.

⁷³ These inventory and reconciliation processes are performed by an independent firm and BellSouth personnel.

⁷⁴ Each state establishes their own inventory schedule for the eight-year period and randomly assigns central offices to a particular year ensuring that all offices are covered in the eight-year period.

BellSouth books all adjustments to reflect any discrepancies found during these inventories and reconciliations of the Hard-Wired and Plug-In Equipment.

Accordingly, BellSouth is in fact performing the recommendation made by the auditors in a manner consistent with ordinary business practices. BellSouth maintains that this program combined with its other recommendations better achieve the general goal of the audit – improvement of BellSouth's records. For example, included in the review of its practices, procedures, and controls,⁷⁵ BellSouth would engage the independent auditor to also review its practices and procedures for performing the inventories and reconciliations of its COE. BellSouth would implement procedures suggested by the independent auditors, if any, into the inventory process to ensure that the process is functioning properly. Moreover, BellSouth would summarize any adjusting entries made and provide that material to the Commission.

The Report does not specify the time frame when the inventory proposed by the auditors in their second recommendation would have to be completed. BellSouth believes that its current cycle schedule is aggressive but does not cause a major disruption of normal business activities. Disruption of normal business activities should of course be an important consideration of any actions resulting from the audit, especially considering that the personnel and systems in question are instrumental to providing local service at a high quality. An inventory of the entire COE is a major undertaking. It requires experienced people, both external with the independent firm and internal, and thousands of work hours to complete. Thus, the personnel resources alone to complete such a task are confined and present significant limitations to accelerating the time of completion.⁷⁶ Even if the external personnel were available to accelerate the timing, the need

⁷⁵ See *infra* BellSouth Response to Issue 7.

⁷⁶ The cost of an inventory obviously increases in proportion to the time of acceleration. Thus, the cost could be astronomical depending upon the time frame requested. This, of course,

for internal personnel would be magnified and therefore disrupt business activities. Such disruption could lead to the types of errors that the inventory is attempting to correct. Moreover, any concern that the auditors may have about the present condition of the investment accounts while the inventories and reconciliations are going through their cycles would be alleviated by the results of the statistically valid sample based inventory and reconciliation discussed above.

The recommendations proposed by BellSouth above not only provide a better basis to achieve the goal of the staff audit, but also allow the Commission more efficient use of its resources. It is BellSouth's understanding that the Commission staff is planning to perform an audit of Plug-In Equipment as phase II of the current audit. As discussed in BellSouth's Recommendation 2, BellSouth's proposal includes engaging the independent firm to perform a statistically valid sample based inventory and reconciliation of the entire COE, including Plug-In Equipment. This would provide the Commission with a verification of the Plug-In Equipment by an independent firm and therefore obviate the need for the Commission staff to perform the audit.

ISSUE 7: The recommendation of the auditors that, in order to improve the likelihood that the CPRs will be maintained correctly in the future, the companies should be required to engage independent auditors to review their practices, procedures, and controls for maintaining CPRs and to make recommendations for improving these systems so that the CPR plant balances can be maintained in compliance with the Commission's rules (parties should address the specific recommendations concerning the practices, procedures, and controls addressed by the auditors in the recommendations sections of the audit reports

BellSouth believes that any recommendation that fosters the continued compliance with the current CPR rules overlooks the real problem and violates the Act. The goal of the

presumes that enough trained personnel exist to perform the inventory in the time frame requested.

Commission should not be to inflict more requirements to enforce the outdated CPR rules. Price cap regulation obviates the need for detailed records of a company's fixed plant assets.

Moreover, as demonstrated in response to Issue 8 *infra*, there is no other regulatory need to maintain such granular rules for fixed plant assets. Instead the Commission must exercise its authority for forbearance under Section 10 of the 1996 Act and rid the large LECs of the CPR pestilence. Requiring the large LECs to have an independent review of their controls so to ensure compliance with the CPR is akin to requiring a municipality to endure a review to make sure its rules protecting horse and buggies from motor cars are in place and working properly.

BellSouth recognizes the importance of maintaining accurate investment of its fixed plant assets. Indeed, BellSouth fully believes that its records accurately reflect the investment of all of its fixed asset accounts. A major part of this confidence is based upon the controls and procedures it has in place to record asset acquisitions and retirements. BellSouth recognizes that these controls and procedures are invaluable to ensure that investment is recorded properly. Indeed, it spends millions of dollars each year on internal resources to ensure compliance with such controls and procedures; and these controls and procedures are reviewed each year by PricewaterhouseCoopers, BellSouth's external auditors, in connection with its annual financial audit. These controls and procedures are an integral part of the accounting process to make sure that such investment is accurate in every respect. Accurately recorded investment, however, does not require the minutia of rules that are currently found in the CPR. Accordingly, a review of internal controls to ensure compliance with the CPR will only ensure compliance of rules that are in place for the sake of having rules. The Commission should therefore forbear from CPR enforcement and abandon any recommendation for CPR control compliance.

If the Commission chooses to ignore its mandate under Section 10 of the 1996 Act, without waiving any rights it is afforded under Section 10 of the 1996 Act; BellSouth will not object to having a review of its practices, procedures, and controls for maintaining its CPR performed by an independent auditor. BellSouth therefore would agree to engage an independent auditor to perform this review in conjunction with its other recommendations set forth in Issue 6, *supra*. Once the review of the practices, procedures, and controls is completed, BellSouth would implement any reasonable suggestions made by the independent auditor. BellSouth would also report to the Commission the results of the review and the steps BellSouth took to implement changes, if any.

ISSUE 8: What ratepayer impact, if any, the alleged discrepancies in the CPR may have had, e.g., through the derivation of the Commission's price cap rates, including re-initialization of price caps, sharing, lower formula adjustments, exogenous cost calculations, and changes to or setting of the productivity factors, joint cost allocations, separations, access charges, and ultimately ratemaking

As a preface to the discussion of this issue, one must understand standard fixed asset and remaining life depreciation accounting practiced by BellSouth. The underlying purpose for the capitalization and depreciation of an asset is to recognize the cost of that asset proportionally over its service life. The methodologies that are applied to this process ensure that the original cost of the asset less any net salvage, and no more, is recognized as depreciation expense over the estimated service life of the asset. The acquisition of fixed plant, such as central office equipment, initiates the recording of the plant in the balance sheet as a fixed asset. A portion of these assets is expensed each year through depreciation expense. When depreciation expense is recorded, a corresponding increase is made to accumulated depreciation, a contra-asset account. Net investment in fixed assets is the difference between the fixed asset accounts and the

accumulated depreciation accounts. Accordingly, the recording of depreciation expense yields a reduction in the net investment in fixed assets, and therefore the rate base. Conversely, when an asset is retired it is removed from both fixed assets and accumulated depreciation, consequently net investment is unaffected.

Pursuant to these practices, an overstatement of plant balances due to inadvertent failure to retire an asset when it is physically removed will have no impact on net investment because proper retirement of the plant would have resulted in a corresponding reduction to the associated accumulated depreciation reserve. Therefore, retiring the investments cited in the Report would have no impact on ratemaking or customers.⁷⁷

Additionally, the principles of the remaining life depreciation methodology produce depreciation expense amounts that are not impacted by an inaccuracy in retirement reporting. To demonstrate the self-correcting nature of the remaining life methodology, BellSouth prepared the attached Exhibit 6 which calculates depreciation expense and revenue requirements for three plant assets under two scenarios. The first scenario demonstrates the amounts for depreciation and revenue requirements which would result from the proper recording of additions and retirements associated with three assets. The second scenario contains the same calculations as the first scenario, but the retirement for the asset placed in Year 3 is purposefully not recorded. A comparison of the Scenario 1 with Scenario 2 quickly shows that no difference is created in depreciation expense or revenue requirements as a result of the failure to report the retirement. The only differences appear in the gross investment and depreciation reserve balances. Because

⁷⁷ Arguably, if the alleged CPR adjustments were to be made, a small impact on interstate depreciation expenses could occur, depending on the timing of the update to depreciation rates. BellSouth demonstrates below, however, under the remaining life methodology investment changes are offset by changes in depreciation rates since depreciation reserve is a component of the rate formula. Therefore, a reduction in investment would be offset by an increase in rates